Internal Revenue Service

memorandum

CC:TL-N-10085-90
Br2:CTSanderson

date: NOV 2 1990

to: Regional Counsel, North Atlantic
Attn: Theodore J. Kletnick,
International Special Trial Attorney CC:NA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

---

subject: [redacted]

This memorandum is in response to your request for tax litigation advice dated August 30, 1990.[1]

ISSUE

Whether I.R.C. § 1256(f)(1) applies to the hedging transactions at issue if the sole reason the transactions are capital, and thus not subject to the section 1256(e) exemption, is the application of Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

CONCLUSION

Congress enacted a mark-to-market mechanism in section 1256(a) to prevent tax motivated straddle transactions. An exemption from marking-to-market was created for hedging transactions. To deter manipulation of the exemption, Congress enacted the section 1256(f)(1) whipsaw. An assumption underlying the exemption and the whipsaw was that hedging transactions described in section 1256(e) produced ordinary gain and loss. This assumption, at least in part, was probably erroneous in light of Arkansas Best. However, the error of this assumption should not cause the whipsaw to apply to transactions clearly not within the intent or contemplation of Congress. It was not Congress' intent in enacting the whipsaw for it to apply to hedging transactions such as those at issue in the above case. If the transactions are subject to the whipsaw now, it is solely because of the subsequently decided Arkansas Best decision. Accordingly, section 1256(f)(1) should not apply to these transactions. For the purpose of settling this case, we recommend that you not assert section 1256(f)(1).

---

[1] You agreed to withdraw the part of your request concerning [redacted].

FACTS

On October 3, 1988, this office issued a tax litigation advice on [redacted]. The facts of this case were extensively discussed in that memorandum; therefore, the facts are only briefly summarized below.

[redacted]'s [redacted], [redacted] and [redacted] years are docketed before the Tax Court. The case has been calendared for [redacted]; however, your office has informed us that the court has granted a 60 day continuance.

In each of the years at issue, [redacted] executed hedging transactions. The transactions involved positions in physical U.S. Treasury securities. The gains and losses from these transactions were originally reported as ordinary. On the basis of Arkansas Best Corp. v. Commissioner, supra, the examining agent converted the losses to capital. As a protective position, however, the hedging gains were unchanged because of the possible application of section 1256(f)(1).

The National Office recently rejected [redacted]'s proposal to settle the case by approving the use of hedge accounting. Your office has informed us that, nevertheless, [redacted] will concede the character issue as opposed to litigating for ordinary treatment of the losses. However, [redacted]'s representatives have stated that it will litigate unless all of its hedging gains, as well as losses, are converted to capital. Additionally, [redacted] wants a closing agreement stating that its reported hedging gains and losses in later years should also be reported as capital. ([redacted] has been audited through its [redacted] taxable year; there are hedging gains and losses in each year.) Accordingly, it has become necessary to determine the applicability of section 1256(f)(1) to these transactions.

INTRODUCTION

In 1981, Congress enacted section 1256. This provision implemented a mark-to-market mechanism for the taxation of "section 1256 contracts." The purpose of the provision was to prevent tax motivated straddle transactions involving section 1256 contracts.

Hedging transactions are exempted from the mark-to-market system. In order to qualify for the exemption, among other things, the transaction must produce ordinary income or loss under general tax principles. Another requirement is that the transaction must be clearly identified as a hedging transaction.

Section 1256(f)(1) denies capital gain treatment for property identified as part of a hedging transaction. This

provision prevents manipulation of the hedging exemption mentioned above.

The transactions at issue meet all of the requirements of being a hedge under section 1256 with the possible exception that they produce capital gains and losses. However, the gains and losses are capital, if at all, solely due to the decision in Arkansas Best Corporation v. Commissioner, supra. Thus, under the prevailing view of the law when section 1256 was enacted, these transactions were hedges as defined under this section and were not subject to the whipsaw under section 1256(f)(1). Accordingly, and as will be discussed below, Congress did not contemplate the application of the section 1256(f)(1) whipsaw in the type of case at issue.

DISCUSSION

A. The appropriateness of examining the whole statute and the legislative history in determining whether section 1256(f)(1) should apply.

Section 1256(f)(1) provides:

(f) Special Rules-

> (1) Denial of capital gains treatment for property identified as part of a hedging transaction - For purposes of this title, gain from any property shall in no event be considered a gain from the sale or exchange of a capital asset if such property was at any time personal property (as defined in section 1092(d)(1)) identified under subsection (e)(2)(C) by the taxpayer as being part of a hedging transaction.

While subsection (f)(1)'s language is arguably unambiguous on its face, in determining whether the section should apply, it is appropriate to consider the whole of section 1256 and the purpose of Congress in enacting this section. As the Tax Court stated in Lartobe Steel Company v. Commissioner, 62 T.C. 456, 452 (1974):

> Although a literal interpretation of the first sentence of section 404(a) would appear to support the position of respondent, we are not confined to such a literal reading in order to construe the intended meaning of this section. Rather, it is our duty to give effect to the intent of Congress by interpreting the general words of a section

> with reference to the whole statute, the purpose for which it was enacted, and its antecedent history. Helvering v. N.Y. Trust Co., 292 U.S. 455 (1934).

More recently, the Tax Court stated in Centel Communications Company, Inc. v. Commissioner, 92 T.C. 612, 628 (March 23, 1989):

> In addition, we may seek out any reliable evidence as to the legislative purpose even where the statute is clear. United States v. American Trucking Associations, Inc., 310 U.S. 534, 543-544 (1940); U.S. Padding Corp. v. Commissioner, [88 T.C. 177, (1987) aff'd, 865 F.2d 750 (6th Cir. 1989)]; Estate of Baumgardner v. Commissioner, 85 T.C. 445, 451 (1985); Huntsberry v. Commissioner, 83 T.C. 742, 747-748 (1984); J.C. Penney Co. v. Commissioner, [37 T.C. 1013, 1019 (1962), aff'd, 312 F.2d 65 (2d Cir. 1962)].

Therefore, although section 1256(f)(1) may appear unambiguous, resort can be made "to the whole statute, the purpose for which it was enacted, and its antecedent history" in determining whether it should apply under a given set of facts. Lartobe Steel Company, supra. When this is done, it is clear that Congress, when it enacted section 1256(f)(1), did not contemplate the application of the section 1256(f)(1) whipsaw in the type of case at issue.

B. The operation and purpose of section 1256.

The operative provision of section 1256 is contained in subsection (a):

SEC. 1256 SECTION 1256 CONTRACTS MARKED TO MARKET.

> (a) General Rule-For purposes of this subtitle-
>
> (1) each section 1256 contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year),
>
> (2) proper adjustment shall be made in the amount of any gain or loss subsequently

realized for gain or loss taken into account by reason of paragraph (1),

(3) any gain or loss with respect to a section 1256 contract shall be treated as-
(A) short-term capital gain or loss, to the extent of 40 percent of such gain or loss, and
(B) long-term capital gain or loss, to the extent of 60 percent of such gain or loss, and

(4) if all the offsetting positions making up any straddle consist of section 1256 contracts to which this section applies (and such straddle is not part of a larger straddle), sections 1092 and 263(g) shall not apply with respect to such straddle.

Congress' purpose in enacting section 1256 in 1981 was to prevent tax motivated straddle transactions involving section 1256 contracts.[2] S. Rep. No. 144, 97th Cong., 1st Sess. 1 (1981), 1981-2 C.B. 474. To this end, the mark-to-market mechanism of subsection (a)(1) above was adopted. Generally, this mechanism requires year end recognition of all unrealized gains and losses on section 1256 contracts. The potential for deferring unrelated gains by using straddles was consequently eliminated. See S. Rep. No. 144, supra, 1981-2 C.B. 474-75.

In what has been reported as a compromise among legislators, the "60/40" capital treatment of subsection (a)(3) above was enacted. This resulted (at least in 1982) in a top rate of tax of 32 percent on section 1256 contracts. S. Rep. No. 144, supra, 1981-2 C.B. 475. Congress intended, however, that the 60/40 treatment apply only to 1256 contracts which were capital assets under other legal principles; "[a]ny ordinary income or loss on the mark-to-market system continued to be taxed at regular rates." Id.

The above intent was manifested in section 1256(f)(2): "Paragraph (3) of subsection (a) shall not apply to any gain or loss which, but for such paragraph, would be ordinary income or loss." Thus, Congress did not intend in enacting section 1256 to change the existing law as to the character of gain or loss from a section 1256 contract (or any other asset), or to enact new law in this regard.

---

[2] As to what is a section 1256 contract, it is sufficient for these purposes to know that a futures contract is such a contract while a transaction in a physical security, as done by [redacted], is not. I.R.C. § 1256(b).

C. The hedging exemption from marking-to-market.

The only transactions Congress exempted from the mark-to-market rules of section 1256(a), assuming such rules otherwise applied, were hedging transactions. S. Rep. No. 144, supra, 1981-2 C.B. 475-76. The exemption is codified in section 1256(e):

> (e) Mark to Market not to apply to Hedging Transactions-
>
> (1) Section not to apply. -Subsection (a) shall not apply in the case of a hedging transaction.
>
> (2) Definition of hedging transaction-For purposes of this subsection, the term "hedging transaction" means any transaction if-
> (A) such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily-
> (i) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or
> (ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer,
> (B) the gain or loss on such transactions is treated as ordinary income or loss, and
> (C) before the close of the day on which such transaction was entered into (or such earlier time as the Secretary may prescribe by regulations), the taxpayer clearly identifies such transaction as being a hedging transaction.

Congress' reason for exempting hedging[3] transactions from marking-to-market was its recognition that hedging transactions are not as likely to be manipulated for tax purposes as are other 1256 contract transactions. See S. Rep. No. 144, supra,

---

[3] The term hedging is used in various contexts other than that within the contemplation of section 1256(e). In this memorandum, all reference to hedging is intended to mean only the type of hedges within the context of section 1256(e) (i.e., so-called "business hedges").

1981-2 C.B. 476. See also S. Rep. No. 144, supra, 1981-2 C.B. 473 ("Because the committee recognizes that certain legitimate business transactions, such as hedging, which result only in ordinary income or loss, lack significant tax avoidance potential, it exempts such activities from the bill's rules on 'cash and carry' transactions.")

Subsection (e) above sets forth certain requirements that must be met for a section 1256 contract transaction to be considered a hedging transaction entitled to the exemption. Generally, the transaction first must be executed in the taxpayer's normal course of trade or business primarily to reduce certain enumerated risks. I.R.C. § 1256(e)(2)(A); S. Rep. No. 144, supra, 1981-2 C.B. 476. Next, the gain or loss on such transactions must be ordinary income or loss. I.R.C. § 1256(e)(2)(B); S. Rep. No. 144, supra. Finally, the transaction must be clearly identified as a hedging transaction before the close of the day on which it was executed. I.R.C. § 1256(e)(2)(C); S. Rep. No. 144, supra.

As discussed more fully below, Congress assumed in enacting the exemption that hedges produced ordinary gain and loss. However, it is significant that the presumed character of the transactions was not the reason for the exemption. The basis for the exemption was Congress' recognition that hedges, because of their purpose, were not as likely to be manipulated by the taxpayer for tax avoidance purposes as were other transactions; therefore, Congress did not see the need to put such transactions on a mark-to-market system. See S. Rep. No. 144, supra, 1981-2 C.B. 473 & 476. Presumably, Congress would have exempted hedging transactions from marking-to-market even if the transactions had been capital under Congress' then understanding of the law. The requirement that a transaction produce ordinary gain or loss was merely Congress' attempt to define, under its then understanding of the law, the type of transaction that it wanted exempted from the mark-to-market requirements.

Of course, with an exemption from the mark-to-market requirements, Congress recognized the danger that the exemption also may be manipulated. S. Rep. No. 144, supra.

D. Section 1256(f)(1) as an antimanipulation provision.

In enacting the hedging exemption, Congress stated its concern with the "danger of manipulation" in circumstances "where taxpayers do not maintain and manage their ordinary income transactions separately from their capital transactions." S. Rep. No. 144, supra, 1981-2 C.B. 476. There are two levels of potential manipulation in this regard. First, a taxpayer may attempt to disguise a speculative, or other nonhedge, transaction as a hedging transaction so as to avoid marking-to-

market under section 1256 or to increase the likelihood of the transaction successfully qualifying for ordinary treatment for any losses, or both. Additionally, by falling under the hedging exemption from marking-to-market, there would exist "opportunities for manipulation of transactions to obtain deferral or conversion of income." S. Rep. No. 144, supra.

As stated earlier, section 1256(f)(1) denies capital gain from any property "identified under subsection (e)(2)(C) by the taxpayer as being part of a hedging transaction." Congress expressed its intent to enact this provision immediately after it stated its concern as to the "danger of manipulation" referred to above; the intent to enact the provision and the concern with manipulation were expressed in the same paragraph. S. Rep. No. 144, supra. Based on this, it appears that Congress' purpose in enacting section 1256(f)(1) was to prevent manipulation of the hedging exemption.

Section 1256(f)(1), in effect, makes the hedging identification under section 1256(e)(2)(C) irrevocable. See S. Rep. No. 144, supra. For example, if a taxpayer identifies a speculative transaction as a hedge on the chance that it may produce a loss, but instead it produces a gain, the taxpayer could not withdraw the identification and take capital gain treatment. On the other hand, if a related speculative transaction, also identified as a hedge by the taxpayer, produces a loss, such loss is capital under general tax principles.[4]

This whipsaw to the taxpayer (i.e., ordinary gain but capital loss on a related transaction) was apparently intended by Congress to prevent manipulation. Id. However, an assumption by Congress underlying section 1256(e) reveals that Congress, in enacting section 1256(f)(1), did not contemplate the application of the section 1256(f)(1) whipsaw in the type of case at issue.

E. Assumption underlying section 1256(e) which should preclude its application in the present case.

Focusing on the whole statute and its legislative history, as discussed above, it seems beyond argument that Congress assumed in enacting section 1256(e) that certain hedging transactions qualified for ordinary treatment under the then prevailing interpretation of the law. See S. Rep. No. 144, supra. Undoubtedly the assumption of ordinary treatment for

---

[4] Of course, the hedging exemption to marking-to-market also would not be available since the transactions would not meet the "ordinary income or loss" requirement of section 1256(e)(2)(B).

hedges was based on the so-called "Corn Products doctrine" or hedging precedents prior to Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), or both.

As it turns out, the assumption, at least as to all hedges described in section 1256(e), was probably erroneous in light of the Supreme Court's interpretation of section 1221 in Arkansas Best.[5] Congress recognized this in the committee report that accompanied the Miscellaneous Revenue Act of 1988. The part of the report pertaining to the amendments to section 988 (discussed below) noted:

> [T]he Supreme Court's March 7, 1988 decision in Arkansas Best Corp. v. Commissioner, narrowly construing an exception from capital asset treatment, has narrowed the classes of transactions generally thought to be eligible for the section 1256(e) exception from mark-to-market treatment . . . .

H.R. Rep. No. 795, 100th Cong., 2d Sess. 1, 569 (1988) (emphasis added).

In light of this erroneous assumption, at least some of the hedges that Congress thought produce ordinary gain and loss instead result in capital gain and loss; however, section 1256(f)(1) would nevertheless require taxpayers to report gains from such hedges as ordinary. This outcome was not contemplated by Congress when it enacted section 1256(f)(1).

As pointed out above, while Congress feared some degree of manipulation with hedges, this fear was not as great as it was with speculative, or other nonhedge, transactions. See S. Rep. No. 144, supra, 1981-2 C.B. 476. Section 1256(f)(1) was aimed at taxpayers who attempted to manipulate the hedging exemption with nonhedge transactions. That simply did not occur in this case.

Furthermore, Congress certainly did not contemplate section 1256(f)(1) applying to a transaction that would have produced ordinary gain and loss under Congress' then understanding of the law. If the transaction produced ordinary income irrespective of the identification, as a hedge transaction would under Congress' assumption, applying section 1256(f)(1) would not have made any sense. In enacting section 1256(f)(1), Congress had in mind those types of transactions that were capital under Congress' understanding of the law prior to Arkansas Best, which does not include the transactions at issue.

---

[5] This memorandum does not address the impact of Arkansas Best on section 1256(e) or the character issue in general.

F. Counterargument for applying section 1256(f)(1) to hedge transactions.

We point out that an argument can be made for the continued assertion of section 1256(f)(1) with hedge transactions. Support for the continued assertion can be based on the subsection's plain language and on Congress' failure to amend or clarify the subsection after Arkansas Best, particularly in light of the above quoted legislative history to the 1988 amendments to section 988.

The above referenced legislation amended section 988 to eliminate the "carve-out" from section 988 that had existed for marked-to-market section 1256 contracts. Under the amendment, "a forward contract, futures contract, option, or similar financial instrument that is subject to the section 1256 mark-to-market rule is nevertheless also a section 988 transaction, assuming that the instrument otherwise meets the section 988 transaction definition." H.R. Rep. No. 795, supra. Unless regulations provide otherwise, the general rule for section 988 transactions is ordinary gain or loss. Id. The elimination of the carve-out was in part due to the uncertainty caused by Arkansas Best as to the character of foreign currency hedges involving section 1256 contracts and the scope of the section 1256(e) exemption in respect to such transactions. Id. See Barnes Group v. United States, 697 F. Supp. 591 (D. Conn. 1988), which followed Arkansas Best in holding that a loss recognized on a foreign currency exchange contract used to hedge against a change in the value of Swedish krona was capital.

It could be argued that Congress' failure after Arkansas Best to enact legislation clarifying that all section 1256(e) hedges are ordinary supports the view that all section 1256(e) hedges are capital except for foreign currency hedges covered by section 988 and certain inventory hedges. This argument is supported by Congress' express recognition in the section 988 legislative history that Arkansas Best "narrowed the classes of transactions generally thought to be eligible for the section 1256(e) exception from mark-to-market treatment." H.R. Rep. No. 795, supra. See 2A Singer, Sutherland Statutory Construction § 49.10 (4th ed. 1984).

Similarly, it could also be argued that, since Congress did not amend section 1256(f)(1), the whipsaw should apply to all hedges that are capital although it would not have applied under pre-Arkansas Best law. However, no reference was made to section 1256(f)(1) in the legislative history, and the better reasoning is to assume for the purpose of this case that Congress thought that the Service would continue to employ the whipsaw in a manner consistent with its purpose (as discussed above) and so as to not work an inequitable result.

G. The remaining viability of section 1256(f)(1) to nonhedge transactions.

We point out that an interpretation of section 1256(f)(1) so that it does not apply to the hedges in this case does not vitiate its application in nonhedge cases. It would still apply to transactions that are capital before and after Arkansas Best. For example, if a speculative futures straddle is identified as a hedge under section 1256(e)(2)(C), it would not be entitled to the hedging exemption "because futures speculation always produce only capital gains or capital losses," thus failing to meet the "ordinary income or loss" test of section 1256(e)(2)(B). S. Rep. No. 144, supra, 1981-2 C.B. 476. However, because of the identification, the gain from the transaction would be ordinary under section 1256(f)(1). This is the type of transaction that Congress clearly intended to catch with section 1256(f)(1). See Id.

This interpretation of section 1256(f)(1) would prevent its application only when the sole reason that the transaction is not a section 1256(e) hedge is due to Arkansas Best. However, even as to such a transaction, the section could apply at a later date. For example, if the Service announced a position that followed Arkansas Best, and a taxpayer subsequently identified a liability hedge as a section 1256(e) hedge and reported ordinary gain and loss, it would seem reasonable for the Service to assert section 1256(f)(1). Furthermore, if the Service was to announce such a position, section 1256(f)(1) may even be appropriate in the case at hand if the petitioner was to continue to litigate for ordinary treatment.

H. Summary and recommendation.

Congress enacted a mark-to-market mechanism in section 1256(a) to prevent tax motivated straddle transactions. An exemption from marking-to-market was created for hedging transactions. To deter manipulation of the exemption, Congress enacted the section 1256(f)(1) whipsaw. An assumption underlying the exemption and the whipsaw was that hedging transactions described in section 1256(e) produced ordinary gain and loss. This assumption, at least in part, was probably erroneous in light of Arkansas Best. However, the error of this assumption should not cause the whipsaw to apply to transactions clearly not within the intent or contemplation of Congress. It was not Congress' intent in enacting the whipsaw for it to apply to hedging transactions such as those at issue in this case. If the transactions are subject to the whipsaw now, it is solely because of the subsequently decided Arkansas Best decision. Accordingly, section 1256(f)(1) should not apply to these transactions.

Based on the above, we recommend the concession of the section 1256(f)(1) issue with [redacted], for docketed and audited years, provided [redacted] agrees to capital loss treatment for docketed and audited years. No agreement should be made concerning years that have not been audited.

We caution, however, that no definitive conclusion has been reached on the application of Arkansas Best to hedging transactions. Furthermore, as discussed above, there are arguments that can be made for the continued assertion of section 1256(f)(1) in hedging cases even if they are affected by Arkansas Best. This tax litigation advice recommends only that section 1256(f)(1) not be asserted in this case for the purpose of settling the case. If the issue arises in other cases, you should request technical advice from the National Office.

MARLENE GROSS

By: Clifford M. Harbourt
CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch No. 2
Tax Litigation Division